



California Public Employees' Retirement System
Office of Governmental Affairs
P.O. Box 942720
Sacramento, CA 94229-2720
TTY: (916) 795-3240
(916) 795-3689 phone • (916) 795-3270 fax
www.calpers.ca.gov

Agenda Item 7a

June 13, 2011

TO: MEMBERS OF THE INVESTMENT COMMITTEE

- I. **SUBJECT:** AB 1151 (Feuer) – As Amended May 5, 2011
Fiduciary Determinations for Iran Divestment
- II. **PROGRAM:** Legislation
- III. **RECOMMENDATION:** Oppose
- IV. **ANALYSIS:**

Summary

Existing law allows the CalPERS Board of Administration (Board) to take action as described in the California Public Divest from Iran Act (Act) when it determines such action would be consistent with its fiduciary duties as described in the California Constitution. The Act also establishes an ongoing review process for CalPERS to engage and monitor companies with investments in Iran that are subject to the Act.

This bill requires the Board not to invest, or to divest, unless it determines, in a public hearing of the full Board, that such action would be a breach of its fiduciary duties. The bill also requires the Board to make additional findings in public meetings and make additional public notices prior to meetings.

Background

Constitutional Authority and Fiduciary Responsibility

Article XVI, section 17 of the California Constitution gives the boards of public retirement systems in California plenary authority and fiduciary responsibility for investment of pension assets and administration of the system. The Constitution expressly provides that the retirement board of a public pension fund shall have the sole and exclusive fiduciary responsibility over the assets of the public pension or retirement system. It further requires the fiduciary of the public pension or retirement system to discharge his or her duties solely in the interest of, and for the "exclusive purposes of providing benefits to participants and their beneficiaries, minimizing employer contributions thereto, and defraying reasonable expenses of administering the system." The Constitution also requires the boards of public pension funds to "diversify the investments of the

system so as to minimize the risk of loss and to maximize the rate of return, unless under the circumstances it is clearly not prudent to do so.”

The Constitution, however, provides that the Legislature may by statute continue to prohibit certain investments by a retirement board where it is in the public interest to do so, and provided that the prohibition satisfies the standards of fiduciary care and loyalty required of a retirement board.

In accordance to the California Constitution Article XVI, Section 17, the Board’s constitutional duties take precedence over any other considerations. Other considerations will be entertained only when not in conflict with any of these duties.

Bagley-Keene Open Meeting Law

The CalPERS Board of Administration conducts its meetings pursuant to the Bagley-Keene Open Meeting Act, which declares that it is the public policy of this State that public agencies exist to aid in the conduct of the people's business and the proceedings of public agencies be conducted openly so that the public may remain informed. Within this open meeting act is a provision that specifically authorizes a state body that invests retirement, pension, or endowment funds, such as the CalPERS Board, to meet in closed session when considering investment decisions.

In addition to the specific investment related exemption, the law authorizes closed sessions for personnel issues, legal issues, for health plan rate negotiations, and security/terrorist issues.

California Public Divest from Iran Act

The California Public Divest from Iran Act (AB 221-Anderson, Chapter 671, Statutes of 2007) prohibits CalPERS and CalSTRS from investing public employee retirement funds in a company with active business operations in Iran 1) meeting specific conditions related defense, oil, nuclear, or natural gas sectors, or 2) are engaged in business operations with an Iranian organization labeled as a terrorist organization by the U.S. Government. Among other things, the Act requires CalPERS to identify and send written notice to a company with business operations in Iran that the company may be subject to the Act, then requires a process of engagement with and monitoring of companies with investments within the scope of the Act.

For companies that fail to complete substantial action to divest within 12 months of notice, the Act requires the Board to refrain from new or renewed investments in that company, and requires the Board to liquidate investments in that company within 18 months and in a manner consistent with the Board's constitutional fiduciary responsibilities.

The Act requires the Board to report to Legislature on or before January 1, 2009, and every year thereafter, with specific information on investments that are subject to the Act and the status of companies with investments subject to the Act. The Act would be repealed when the U.S. Department of State removes Iran from its list of terrorist countries and the President certifies that Iran has ceased its nuclear weapons research. In addition, AB 221 (the bill that originally created the Act) provided for a separate code section that indemnifies present, future and former Board Members of CalPERS and CalSTRS, jointly and individually, along with State officers, employees, the research firm, employees, and investment managers, but does not indemnify the fund.

Related Federal Legislation

The federal government recently enacted the Comprehensive Iran Sanctions, Accountability, and Divestment Act of 2010, to strengthen existing federal law imposing sanctions on Iran by generally tightening investment thresholds and definitions. The act also tightens export prohibitions to countries that are deemed to be diversion points for weapons related technology being sold to Iran. It further shields certified investment companies, and their executives, from civil, criminal, or administrative action resulting from a decision to divest in Iran's energy sector. Finally, the act expresses the sense of Congress that it is not a breach of fiduciary responsibility for a pension plan, governed by the Employee Retirement Income Security Act of 1974 (ERISA), to divest from Iran's energy sector, if the divestment determination 1) is reached using credible, publically available information, and 2) does not provide a lower rate of return or provide a higher rate of risk. However, these safe harbor and fiduciary responsibility provisions do not apply to CalPERS since it is not governed by ERISA.

As the act relates to Iran divestment, it authorizes state and local governments to divest their assets in companies with more than \$20 million invested in the Iranian energy sector, which is intended to prevent legal challenges based on federal preemption.

Proposed Changes

Specifically, Assembly Bill 1151 does the following:

1. Changes the Board's responsibilities under the California Public Divest from Iran Act (Act) by requiring the full Board to make a determination when it does not divest from a company subject to the Act that such action would be a breach of constitutional fiduciary responsibilities. Existing law under the Act allows the Board to make divestment decisions based on whether such actions are consistent with its fiduciary responsibilities.
2. Requires any determination that a company has made substantial action or sufficient progress toward divesting from Iran be made within a 90 day timeframe and be supported by findings adopted by a roll call vote of the Board following a presentation and discussion of the findings in open session, during a properly noticed public hearing of the full Board. The bill further requires that the proposed findings be made public 72 hours before they are considered by the Board.
3. Requires the Board to maintain a list of interested parties and notify that list of parties of the proposed findings 72 hours before the Board considers the findings related to a company that has made substantial action or sufficient progress toward divesting from Iran. The bill also requires that these findings be included in CalPERS' report to the Legislature.
4. Revises the criteria for companies that have business operations in Iran, which would then be subject to divestment by the Board, including establishing a \$20 million investment threshold, redefining industry sectors subject to divestment to include the energy sector, and revising the definition of Iran. The bill also eliminates existing exemptions from the Act for companies engaged in certain humanitarian, educational, religious, journalistic or welfare activities. These provisions appear to be intended to better conform State law to recently enacted federal law.
5. Requires the Board to annually review its investment portfolio based on publicly available information. Existing law set a June 30, 2008, deadline for this review.
6. States that the provisions and applications of the Act are severable, and that if any provision is held invalid, then that invalidity shall not affect other provisions or applications that can be given effect without the invalid provisions or applications.

Legislative History

- 2011 SB 903 (Anderson) – Changes the Board's authority to make divestment determinations under the California Public Divest from Iran Act. Existing law allows the Board to take action as described in the Act when it determines such action would be consistent with its fiduciary duties as described in the California Constitution. This bill requires the Board to make a divestment determination in a public meeting if such action would be a breach of its fiduciary duties. *CalPERS Position: Pending*
- 2007 Chapter 671 (AB 221, Anderson) – Prohibits the CalPERS and CalSTRS from investing in a company that is invested or is engaged in business operations with entities in the defense or nuclear sectors of Iran, or in the development of petroleum or natural gas resources of Iran; and that company is subject to sanctions under Public Law 104-172. Also, the bill would require the boards of these retirement systems to sell or transfer any investments in these companies and report to the Legislature regarding these investments, as well as on costs and losses incurred as a result of the divestment. *CalPERS Position: Oppose*
- 2006 Chapter 442 (AB 2941, Koretz) – Prohibits CalPERS and CalSTRS from investing public employee retirement funds in a company with active business operations in Sudan, and would require the boards of these retirement systems to sell or transfer any investments in these companies within specified timeframes. The boards of these retirement systems would be required to submit a specified annual report to the Legislature on or before January 1, 2008. Although CalPERS typically opposes any divestment legislation, the Board determined this situation was unique enough to approve a neutral with suggested amendments position. The amendments would indemnify the fund (not accepted by author) and ensure the bill does not impact the Supplemental Savings Program (accepted by the author). The Board also directed staff to seek a separate indemnification bill for the fund. Staff did not find an author. *CalPERS Position: Neutral, with suggested amendments.*
- 1967 Chapter 1656 (AB 495) – Revises the open meeting laws that apply to the Board of Administration. Among its provisions, the bill authorizes the Board to meet in closed session when making investment decisions.

Issues

1. Arguments in Support

According to the Sponsor, the Jewish Public Affairs Committee (JPAC):

"It is clear from both legislative oversight hearings and the reports issued by these agencies, particularly CalPERS, that they are avoiding the intent of the Legislature and have not divested. These decisions are based on a questionable interpretation of fiduciary duty. This bill would establish a transparent and public process for such a determination, and would also clarify the burden of making such a finding by shifting the findings burden to a specific determination of inconsistency which is more in line with Legislative intent."

JPAC further adds:

"The State Legislature passed AB 221 to join an international effort, a United States effort and national movements among the states to put international pressure on Iran to end its rogue activities. It is unfortunate that CalPERS continues to defy the Legislature and hide behind fiduciary duty when other states have divested. This bill is a step forward in shedding the light of day on their efforts to avoid divestment."

Organizations in Support:

Jewish Public Affairs Committee (JPAC)

2. Arguments in Opposition

CalSTRS states it: "opposes legislation or regulations that restrict the investment authority of the board or that are inconsistent with its Statement of Investment Responsibility."

Organizations in Opposition:

California Conference of Machinists; California State Teachers' Retirement System (CalSTRS); California Teamsters Public Affairs Council.

3. CalPERS Implementation of the Iran Act

CalPERS has fully implemented the California Public Divest from Iran Act (Act) from the time it became effective on January 1, 2008. CalPERS has submitted each report to the Legislature on time with all the required information. In addition, CalPERS Board Members and staff have testified on numerous occasions to provide updates and information to the Legislature.

CalPERS' 2010 Report on Iran Divestment describes its implementation of the Iran Act during the year, including the active engagement of companies as required by the Act, and the significant number of portfolio companies curtailing their activities in Iran or withdrawing from Iran. It noted that companies' withdrawal from Iran accelerated through the imposition of economic sanctions on Iran by the United Nations, the European Union, Japan, South Korea, and the United States.

Examples of major multinationals which withdrew from Iran in 2010 include Royal Dutch Shell, which announced that it has agreed to terminate its investments and avoid any new activity in Iran's energy sector in full compliance with the newly expanded U.S. legislation. Likewise, France's Total SA, Norway's Statoil ASA, Brasil's Petrobras and Italy's Eni Spa have also agreed to end all investments in Iran. CalPERS has been calling for withdrawal by these companies since the inception of the Act, and has actively engaged their senior management and boards through correspondence and in person meetings.

The Report also noted that withdrawals by these major multinational corporations reduced the value of CalPERS portfolio holdings in companies subject to the Act from \$2 billion to approximately \$300 million, prompting CalPERS to commission a new fiduciary analysis to establish the impact of potential divestment on the portfolio, while it continues to identify companies potentially subject to the Act, to notify them of the law's provisions, and call for their taking of substantial action or withdrawal from Iran.

In May 2011, the Board decided to divest from remaining companies doing business in Iran and Sudan. This action could only be taken as the fiduciary analysis shows there will be no impact on portfolio risk and minimal trading costs, which will be offset by modifying compliance activities. CalPERS will continue to identify, monitor and rigorously engage companies in its portfolio and review their status under the California Public Divest From Iran Act.

4. Closed Session and the Board's Constitutional Plenary Authority and Fiduciary Responsibility for Investment

CalPERS is the largest public pension plan in the United States, responsible for over \$230 billion in global assets, which are invested to provide retirement benefits for over 1.6 million members and retirees. As discussed above, the Board has the exclusive authority and sole responsibility to administer System funds to provide benefits to participants and their beneficiaries, minimizing employer contributions thereto, and defraying reasonable expenses of administering the System. This authority and responsibility comes from Section 17 of Article XVI of the State Constitution. While CalPERS opposed AB 221, which enacted the California Public Divest from Iran Act (Act), the legislation contained provisions that acknowledged the primacy of the Board's constitutional responsibilities.

Existing Board Policy regarding closed sessions recognizes the interplay between constitutional plenary authority and fiduciary responsibility and the open meeting laws that govern the Board, and is intended to achieve and harmonize two objectives: 1) To fulfill its constitutional duty to CalPERS participants to act with the care, skill, prudence and diligence as would a prudent expert, and 2) To fulfill its strategic goal of establishing CalPERS' identity as a trustworthy, equitable, cost-effective, responsive, and well-managed organization.

The Policy states that the Board will meet in closed session to discuss investment matters when a public discussion is likely to impair CalPERS' ability to achieve its investment objectives. Two specific situations that trigger a closed session are the discussion of 1) activity reports concerning the screening and review of potential investments, and 2) decisions to terminate the contracts of external managers or advisors, when those decisions are inherently tied to the possible liquidation of an asset being managed or held by the manager/advisor.

CalPERS must protect its right to discuss investment decisions in closed session. If analyses regarding due diligence and investment strategy were to be made in open session, there could be immediate, unintended consequences in the public and private markets. Due to this possible negative market impact, it is imperative that CalPERS retain the ability to analyze and make investment decisions in closed session.

The Act, currently, does not require divestment decisions to be made in a public meeting, allowing the Board to operate pursuant its constitutional responsibilities and state open meeting laws. AB 1151 requires the Board to

make determinations related to investments identified in the Act in public meetings. Because Board decisions to divest or not divest under the Act would almost certainly deal with a single company or portfolio and would fall within one or both of the closed session scenarios, AB 1151 seeks to force the Board to violate its Policy, which has the express purpose of fulfilling the Board's constitutional duty.

The public meeting requirement in this bill imposes a requirement that is contrary to Board Policy and could be a source of potential violations of the Board's constitutional plenary authority and fiduciary responsibility. As such, the legislation should be amended to allow for current Board Policy to continue guiding when closed sessions may be held.

5. Board Meetings Becoming Overburdened By Divestment

The California Public Divest from Iran Act (Act), currently, adds administrative burden on CalPERS to identify, investigate, monitor, and engage companies with investments in Iran. Assembly Bill 1151 seeks to impose greater requirements on the Board's meetings, particularly by requiring the Board to make divestment determinations in public meetings, maintain a list of parties interested in divestment, and notify these parties at least 72 hours before the Board considers findings related to companies' progress on divesting from Iran.

In addition, the new set of notice and public meeting requirements may not be possible to satisfy, particularly the interaction between the 90 day review period for companies in the stage prior to divestment and the requirement that both a determination and findings be adopted regarding that company and the 72 hours prior notice required for the findings. The bill also does not take into account the potential effects of the 72 hours prior notice of Board findings on the market in general and CalPERS investments in particular. The bill imposes significant process challenges, and would require significant amendments, based on a better understanding of Board process, to be workable.

6. CalPERS' Legislative Policy Standards

The Board's Legislative Policy Standards suggest an oppose position on proposals which impose any investment mandate or restriction on the Board's investment authority, therefore staff recommends the Board adopt an **oppose** position.

AB 1151 seeks to impose a public meeting requirement on the Board that is contrary to Board Policy, State open meeting laws, and imposes a higher standard on the Board's constitutional plenary authority and fiduciary responsibility. The bill also imposes complex administrative burdens on the Board's continuing implementation of the California Public Divest from Iran Act.

V. STRATEGIC PLAN:

This item is not a specific product of the Annual or Strategic Plans, but is a part of the regular and ongoing workload of the Office of Governmental Affairs.

VI. RESULTS/COSTS:

CalPERS Ongoing Monitoring Costs under AB 221 are approximately \$550,000 annually for CalPERS staff costs and external fiduciary counsel. If AB 1151 were to pass, staff expects CalPERS to incur unknown, additional costs beyond the implementation costs for the statute as currently written.

As reported in the December 13, 2010 agenda item:

- CalPERS incurs internal costs in complying with the legislation which encompasses a cross-enterprise approach to implementing the requirements. Compliance with the legislation involves staff from the Investment Office, Legal Office, Governmental Affairs Office, and Office of Public Affairs. The annual costs of complying with the legislation are estimated at approximately \$425,000.
- External costs of complying with the provisions of the legislation are the engagement of an external research group to identify companies that meet the criteria of the legislation, external pension consultant to calculate the costs and assess the impact on CalPERS risk and return profile if CalPERS were to divest its shares in the Covered Companies, and external fiduciary counsel. These annual external costs associated with conforming to the legislation are approximately \$125,000. CalPERS has not incurred any divestment costs or losses.

DANNY BROWN, Chief
Office of Governmental Affairs

JANINE GUILLOT
Chief Operating Investment Officer

PATRICIA K. MACHT
Deputy Executive Officer
External Affairs

JOSEPH A. DEAR
Chief Investment Officer